

Message Text

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SS-15 STR-04 OMB-01 CEA-01 CIAE-00 COME-00 FRB-03

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O R 291632Z JAN 76

FM AMEMBASSY PARIS

TO SECSTATE WASHDC IMMEDIATE 7323

INFO AMEMBASSY BONN

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PASS TREASURY, FEDERAL RESERVE, COMMERCE

E.O. 11652: N/A

TAGS: EFIN, FR

SUBJECT: RECENT FOREX MARKET DEVELOPMENTS IN PERSPECTIVE

REFTELS: PARIS 0482, PARIS 1909; PARIS 1017; PARIS 2021;

PARIS 2242; PARIS 2464; PARIS 2476; PARIS

2660; PARIS 2670

1. THE FOREX CRISES IN RETROSPECT:

LARGELY AS THE RESULT OF AN EMERGING AND WIDELY
FORECAST TRADE AND CURRENT ACCOUNT DEFICIT THE FRENCH
FRANC WAS EXPECTED TO WEAKEN IN 1976. IN ADDITION,
(A) SOBER STATEMENTS ON THE ECONOMIC OUTLOOK BY HIGH
GOVERNMENT AND INDUSTRY OFFICIALS, (B) SOME REVERSAL
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OF SHORT-TERM CAPITAL FLOWS; (C) A SLOWDOWN OF LONG-

TERM CAPITAL INFLOWS AFFECTED BOTH REAL AND PSYCHOLOGICAL FACTORS, ESPECIALLY DURING THE TWO WEEKS PRECEDING THE ITALIAN EXCHANGE CRISES (SEE PARIS 1909 FOR DETAILS). THE FOREX MARKET ALSO WAS AWARE OF GOF DETERMINATION TO REMAIN IN THE EC "SNAKE". IT ALSO WAS AWARE OF CERTAIN ADDITIONAL UNDERLYING FACTORS, E.G., CONTINUING INFLATIONARY PRESSURES RELATIVE TO WEST GERMANY AND CORPORATE CASH FLOW AND PROFIT PROBLEMS. ALTOGETHER THESE FACTORS HAD THE EFFECT OF MAKING THE FRANC A POSSIBLE TARGET OF SPECULATIVE OPPORTUNITY. (SEE PARIS 0482 FOR DETAILS OF THESE UNDERLYING FACTORS AND GOF FOREX POLICY.) THE FOREX CRISIS IN ITALY PROVIDED THE OPPORTUNITY FOR THE MARKET TO TEST THE FRENCH FRANC. IT BEGAN TO DO SO THE DAY THAT THE BANK OF ITALY ANNOUNCED ITS WITHDRAWAL FROM THE ITALIAN FOREX MARKET (SEE PARIS 1909 FOR DETAILS OF THE INITIAL SPECULATION). SPECULATION AGAINST THE FRANC WAS HEAVY FROM WEDNESDAY, JANUARY 21, THROUGH FRIDAY AFTERNOON, JANUARY 27. THE FRENCH AUTHORITIES INTERVENED AT THE MIDPOINT OF THE EC "SNAKE" RATHER THAN ALLOWING THE RATE TO SLIDE, PARTLY AS A TACTIC TO IMPRESS THE MARKET BUT ALSO AS A REFLECTION OF GOF FOREX POLICY (SEE PARIS 0482 AND PARIS 2242 FOR DETAILS). THE SPECULATION WAS BASICALLY AN EXTERNAL DEVELOPMENT, AS REFLECTED BY THE SHARP RISE IN EUROFRANC DEPOSIT RATES CONTRASTED WITH RELATIVELY SMALL CHANGES IN PARIS GOLD PRICES AND OTHER INDICATORS OF DOMESTIC PRESSURE AGAINST THE FRANC (SEE PARIS 1909 AND 2242 FOR DETAILS). BY FRIDAY AFTERNOON, JANUARY 27, SPECULATION PERCEPTIBLY EASED DURING THE SECOND SESSION OF THE FOREX BOURSE AND THE BANK OF FRANCE SUCCEEDED IN CLOSING THE MARKET ON AN UPEAT NOTE (SEE PARIS 2021). ON MONDAY, JANUARY 29, THE PARIS FOREX MARKET WAS RELATIVELY CALM (PARIS 2242) AND BY THE FOLLOWING DAY IT WAS CLEAR THAT THE CRISIS HAD PASSED (PARIS 2660).

2. SIGNIFICANCE AND CONCLUSIONS:

(A) ALL OF THE ELEMENTS THAT MADE THE FRANC A TARGET
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OF SPECULATIVE OPPORTUNITY REMAIN IN PLACE. THUS ANY DEVELOPMENT COULD TRIGGER RENEWED SPECULATION AT ANY TIME. IF THE D-MARK APPRECIATES IN 1976 AS MANY EXPECT, THIS ALONE COULD TRIGGER SPECULATION AGAINST THE FRANC, NOT TO MENTION POSSIBLE DEVELOPMENTS IN ITALY, SPAIN, OR PORTUGAL AND AN ALMOST INFINITE VARIETY OF OTHER POSSIBILITIES.

(B) THE GOF IS COMMITTED TO STAY IN THE EC "SNAKE" AS WELL AS TO A RELATIVELY STRONG FRANC. THIS IS A KEY ELEMENT IN Giscard's economic policy and in a very real sense his personal prestige is on the line (PARIS 1017, 0482, 2464, 2242). This also provides a more or less known target against which a weakening franc conceivably could be pushed. In short, a convenient target for speculation. If heavy pressures develop the GOF might well seek modifications in the

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EC "SNAKE" ARRANGEMENT RATHER THAN FACE THE POLITICALLY HUMILIATING PROSPECTS OF A FORCED WITHDRAWAL. THIS COULD HAVE THE EFFECT OF MAKING THE PRESENT EC "SNAKE" MORE FLEXIBLE. THE ALTERNATIVE

BROADLY SPEAKING WOULD BE SOME KIND OF ACCOMMODATION WITH THE FRG, INCLUDING THE FINANCING NECESSARY TO KEEP THE FRANC IN THE EC "SNAKE".

(C) THE FOREX CRISIS OF LAST WEEK WILL FORCE CONTINUATION OF CAUTIOUS DOMESTIC ECONOMIC POLICIES, FEATURING AN ALMOST RESTRICTIVE MONETARY POLICY IN REAL TERMS AND A RESTRAINED FISCAL POLICY. MEASURES TO REVIVE THE ECONOMY WILL HAVE TO BE SELECTIVE. EXTERNALLY THE GOF PROBABLY WILL REVIVE THE PATTERN OF MEDIUM AND LONG TERM BORROWING EVIDENT IN 1974 AND LIMITED OFFICIAL USE

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1975. MEASURES TO CONTROL INFLATION AND TO EASE CORPORATE FINANCIAL BURDENS (PARIS 0482 AND 0718) PROBABLY WILL RECEIVE EVEN MORE ATTENTION.

(D) IN SUMMARY BECAUSE OF GISCARD'S PERSONAL DECISIONS LAST MAY TO HAVE THE FRANC REJOIN THE EC "SNAKE" GOF ECONOMIC POLICY NOW MUST WALK A VERY NARROW AND HAZARDOUS PATH. NOW EVEN MORE THAN BEFORE A GENERAL ECONOMIC UPTURN IN THE INDUSTRIAL COUNTRIES IS A REQUIREMENT FOR THE SUCCESS OF GOF ECONOMIC POLICIES WHICH ARE QUITE LITERALLY HOSTAGE TO THE VAGARIES OF THE FOREX MARKET. THIS IS NOT AN ENVIALE POSITION BUT THE GOF SHOWS EVERY SIGN OF GREAT DETERMINATION TO PERSEVERE IN ITS POLICIES WHICH PUT A HIGHER PRIORITY ON CONTROLLING INFLATION AND EXTERNAL EQUILIBRIUM THAN IT PUTS UPON MEASURES TO STIMULATE FINAL DEMAND IN THE DOMESTIC ECONOMY.

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